

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-3061-00
HPLevine, ID# 62-09574

date: JUN 27 2000

to: Chief, Examination Division, Kentucky-Tennessee District
Revenue Agents Carla Bellenfant/Mike Prepare'

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [REDACTED]
Capitalization of acquisition costs

By memorandum dated June 5, 2000, we opined on the extent that acquisition costs must be capitalized. the National Office has orally informed us that they agreed that the revenue ruling did not apply and that the services performed were important in determining the extent that the costs must be capitalized. Their only comment was that the distinction between the [REDACTED] through [REDACTED] and [REDACTED] costs be clarified. In this regard, as previously discussed, the [REDACTED] through [REDACTED] costs were those incurred by the taxpayer as an acquirer and the [REDACTED] costs, which included costs which it agreed to pay on behalf of the acquirer, were those incurred as a target.

We are closing our file subject to reopening if additional assistance is necessary. Please contact the undersigned at 250-5072 if you have any questions.

JAMES E. KEETON, JR.
District Counsel

By: 

HOWARD P. LEVINE
Senior Attorney

Office of Chief Counsel
Internal Revenue Service
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DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE:

Whether the taxpayer must capitalize external and internal acquisition costs including salaries of officers directly involved in the mergers and acquisitions?

CONCLUSION:

The taxpayer must capitalize external and internal acquisition costs including salaries of officers directly involved in the mergers and acquisitions?

FACTS AND DISCUSSION:

The taxpayer is a privately owned corporation which operates a national group of [REDACTED]. It has grown to its current size through acquisitions of existing [REDACTED]. This manner of growth is prevalent in the [REDACTED] field. Moreover, the taxpayer has attempted to create a niche through joint ventures with non-profit [REDACTED]. In [REDACTED], it was purchased and taken private by [REDACTED]. The taxpayer incurred [REDACTED] and [REDACTED] costs as a result of the acquisition and subsequent merger.

Expenditures incurred in connection with organizing, recapitalizing or merging a business are not currently deductible. INDOPCO v. Commissioner, 503 U.S. 79 (1992); FMR Corp. v. Commissioner, 110 T.C. 402 (1998). Where a taxpayer receives significant, long-term benefits as a result of the expenditures it incurred in connection with facilitating a capital transaction, the costs must be capitalized. Id. It is undisputed that costs incurred in connection with facilitating a capital transaction, that is, an acquisition, must be capitalized. American Stores Company v. Commissioner, 114 T.C. No. 27 (May 26, 2000). Instrumental to the court's opinion in American Stores Company v. Commissioner, supra, was the fact that the court found that the objective of the merger transaction had long-term benefits, to wit, a greater market share, greater operating efficiencies in the combined operations and adoption of the management/operating policies of the acquired entity.

The Internal Revenue Service in Rev. Rul. 99-23, I.R.B. 1999-20 clarified the extent that expenditures by a taxpayer in the course of a general search for or investigation of an active trade or business were permitted to be amortized as "start-up" expenses under I.R.C. § 195. Rev. Rul. 99-23 does not apply to this case since it applies only to entities not already in a trade or business being considered.¹ The taxpayer was the target of the [REDACTED] transaction and not the predator and therefore did not incur expenses to acquire another business.

¹ I.R.C. § 195 was enacted to equalize the tax treatment between entities allowed to deduct expansion costs and those "start-up" entities who could not do so because they could not satisfy the I.R.C. § 162 "trade or business" requirement. NCNB v. United States, 684 F.2d 285 (4th Cir. 1982); Richmond Television Corporation v. United States, 345 F.2d 901 (4th Cir. 1965). I.R.C. § 195 may apply to [REDACTED] but their expenditures and taxes are not at issue here.

Moreover, the taxpayer was already in the health care business and therefore would be entitled to deductions under I.R.C. § 162 to the extent that there are allowable investigatory expansion costs.

Rev. Rul. 99-23 is an attempt to provide guidance for amortizable investigatory expenses under I.R.C. § 195. A requirement under I.R.C. § 195 is that the expenses must have been allowable under I.R.C. § 162 if the trade or business requirement was met. Therefore, the discussion in Rev. Rul 99-23 may prove instructive.

Under Rev. Rul. 99-23, expenditures incurred in a general search for or investigation of an active trade or business qualify as investigatory costs and are amortizable under I.R.C. § 195. Start-up costs are defined by reference to costs allowable to an existing business which are incurred in connection with investigation of expansion possibilities which were otherwise already deductible. These costs are in general those which are generic to a determination as to whether to enter into a business or market and include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities and like expenses. Rev. Rul. 99-23. It is important to note that these expenses are not those incurred prior to a final decision to acquire a specific business, but whether to enter into that business at all. See Rev. Rul. 99-23. See also Rev. Rul. 77-254, 1977-2 C.B. 63 (expenses incurred in the course of a general search for or an investigation of a business that relate to decisions as to whether to purchase a business and which business to purchase are investigatory costs). Rev. Rul. 99-23 provides the following examples illustrative of these distinctions:

1. Costs incurred to conduct industry research and evaluate publicly available financial information are investigatory costs. Costs incurred to review specific financial information of proposed target to establish purchase price are capital since they were incurred after the decision was made to enter into the new business.
2. Costs incurred to draft regulatory approval documents are capital no matter when they were incurred since the costs were incurred to facilitate and not investigate the acquisition of a business.

3. Due diligence costs including review of internal documents, books and records and drafting acquisition agreements pertain to the attempt to acquire a specific business and are not eligible for amortization under I.R.C. § 195.

You have identified three different types of acquisition costs that you propose to capitalize. These acquisition costs are identified in three separate notices of proposed adjustments (Forms 5701) as follows:

1. External acquisition costs in the amounts of \$ [REDACTED] for [REDACTED] and \$ [REDACTED] for [REDACTED] which pertain to consulting contracts and investment advisor and legal fees.² The [REDACTED] fees specifically relate to the merger and acquisition by the taxpayer of [REDACTED] in [REDACTED]. The [REDACTED] fees pertained to a consulting contract to [REDACTED].
2. Internal acquisition costs for salaries and stock options paid to senior officers in the acquisition and development department between [REDACTED] and [REDACTED].
3. External acquisition costs for payments made to [REDACTED] for strategic planning in the acquisition of [REDACTED].

The expenditures for the external acquisition costs to extent that they pertain to the merger and acquisition by the taxpayer of [REDACTED] in [REDACTED] are clearly required to be capitalized. All of these costs were incurred in connection with facilitating a capital transaction, that is, an acquisition. See Norwest Corporation v. Commissioner, 112 T.C. 89 (1999). None of the expenditures appear to relate to investigatory costs, that is, the pre-decision on whether to acquire the hospitals in general and [REDACTED] in particular.

Whether the payments to [REDACTED] must be capitalized depends on the reason that the payments were made. In your issue proposal, you indicate that [REDACTED] entered into a consulting contract at the same time that negotiations with [REDACTED] were in progress. Prior to the acquisition, [REDACTED] was paid a base salary of \$ [REDACTED]. Although you presume based on the timing of the transactions that the consulting contract pertained

² We understand that the taxpayer now claims that it did not deduct the investment banker or legal fees and that the proposed issue will be adjusted accordingly.

to the acquisition, you do not indicate what services were provided by [REDACTED]. Since the taxpayer bears the burden of establishing that it is entitled to the deduction, you are not required to make further inquiries although the extent that the Internal Revenue Service will be able to sustain the adjustment depends on the nature of the services provided and you may want to secure a copy of the consulting contract and interview [REDACTED] and other persons whom he worked with and/or who hired him to determine the nature of the expected services and what actual services he provided.

The internal acquisition costs for salaries and stock options paid to senior officers in the acquisition and development department is a more difficult determination. These include the salaries of [REDACTED] officers for [REDACTED] and [REDACTED] for [REDACTED] through [REDACTED].³ Your adjustment is apparently based on the fact that the [REDACTED] transaction occurred within the [REDACTED] taxable year and it is probable that all or a substantial part of the time of these officers would have been on this transaction.⁴

To the extent that some or all of these officers spent some or all of their time on investigatory matters, then it is conceivable that some or all of their compensation should be expensed and not capitalized. Considering that [REDACTED] was retained to pursue a strategic transaction in [REDACTED], it is probable that the strategy was pursued in-house for some time prior to that time. The extent that the Internal Revenue Service can sustain these adjustments may be dependent on facts that are ultimately developed and the nature of the services performed by these officers for the affected periods. In this regard, it is conceivable that some worked solely on speculative acquisition strategies while others worked solely on integration. Determining the exact services provided by these officers for the affected periods may have an impact on this adjustment.

³ The [REDACTED] officers whose salaries were included for all years were the [REDACTED]
[REDACTED]

⁴ Your time line indicates that the external decision by the taxpayer to pursue a strategic transaction, that is, to hire an investment banker to pursue sales alternatives, was made in [REDACTED]
[REDACTED]

Because of the scope and nature of the acquisition activities, alternative theories can be pursued for capitalizing these internal salary costs. The taxpayer had a tightly integrated acquisition and development department with an executive officer and subordinate officers in charge of separate acquisition and development departments. The centralization of these departments reflects that they were organized for long-term strategic benefits. In this regard, as framed by the court in American Stores Company v. Commissioner, supra, services performed in the process of effecting a change in corporate structure for the benefit of future operations must be capitalized. See also INDOPCO, Inc. v. Commissioner, supra (expenses directly incurred in reorganizing or restructuring a corporate entity for the benefit of future operations are not deductible).

Since it is the essence of the work performed by at least the senior vice-president of acquisition and development and the vice-president of acquisitions (and possibly the other officers) to effectuate a change in the corporate structure for the benefit of the future operations, a good argument can be made that all of their compensation must be capitalized even if part of it was for investigatory costs. In this regard, as noted by the court in American Stores Company v. Commissioner, supra, expenditures which otherwise might qualify as currently deductible must be capitalized if they are incurred in connection with the acquisition of a capital asset. This is distinguished from the case where a taxpayer pursues isolated business and not like here where the expansions are part of a larger plan for synergistic or other long-term benefits.⁵

In summary, we agree that all three adjustments that you have proposed concerning the capitalization of costs are well-grounded. Each would benefit from factual development to determine the exact nature of the services provided although it is not required since a factual basis has been established for the adjustments and the taxpayer has the burden of proof.

⁵ The Tax Court in Norwest Corporation v. Commissioner, 112 T.C. 89 (1999), held that all costs incurred in connection with a single event, that is, the acquisition transaction, had to be capitalized. We do not believe that the law is necessarily so limited to a single identifiable event. The decisive factor in Norwest was that the transaction lead to a change in the corporate structure, a long-term benefit. When the taxpayer such as here attempts to continuously change its corporate structure through expansion and has a department dedicated solely to that purpose, the costs are necessarily incurred in effectuating a

Because of the fluid and technical nature of this issue, we are seeking post-review by the National Office of the advice contained herein. We expect to hear shortly from them. Attached is a client survey which we request that you consider completing. Please contact the undersigned at 250-5072 if you have any questions.

JAMES E. KEETON, JR.
District Counsel

By:

HOWARD P. LEVINE
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